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Nos. 8 and 23

In the Supreme Court of the United States

OCTOBER TERM, 1966

CHICAGO AND NORTH WESTERN RY. Co., et al., *Appellants,* vs. THE ATCHISON, TOPEKA AND SANTA FE RY. Co., et al., *Appellees.*	No. 8
UNITED STATES OF AMERICA AND INTERSTATE COMMERCE COMMISSION, *Appellants,* vs. THE ATCHISON, TOPEKA AND SANTA FE RY. Co., et al., *Appellees.*	No. 23

On Appeal from the United States District Court for the Southern District of California, Central Division

Brief for Appellees the People of the State of California and the Public Utilities Commission of the State of California

These appeals are from a judgment of the United States District Court for the Southern District of California setting aside the orders of the Interstate Commerce Commis-

sion in certain proceedings identified in the record as Docket No. 31503, the so-called *Transcontinental Divisions* case. Appellees the People of the State of California and the Public Utilities Commission of the State of California participated as interveners in the proceedings before the Commission and as intervening plaintiffs in the action in the district court to set aside the Commission's orders. They appear as appellees before this Court to urge affirmance of the district court's judgment and submit the following brief and argument in support of that position.

QUESTIONS PRESENTED

1. Whether the Commission may lawfully prescribe divisions designed to "reflect certain broader aspects of revenue need" without finding either the extent of the revenue needs of the railroads involved or the financial effect of its orders, where the Commission has been specifically asked to determine the revenue needs of the railroads in order to make certain that its orders would give proper recognition to the public interest in maintaining a rail system capable of meeting the needs of the growing economy of California and other Western States.

2. Whether the Commission's action in discounting the Western railroads' revenue needs because of their high passenger deficits on the theory that these deficits are not permanent in nature constitutes a denial to California and the Western railroads of the fair hearing required by Section 15(6) of the Interstate Commerce Act, where no notice was given prior to the completion of the hearings that the Commission might adopt such a theory, and where there is no evidence in the record which in any way supports the view that the Western railroads' passenger deficits can be eliminated or substantially reduced.

3. Whether appellants can properly defend the Commission's orders in this Court as based wholly upon the Commission's findings on cost of service, where the Commission's reports show that they were not so based, where the appellants themselves asked the district court to uphold the Commission's orders on the basis of its findings with respect to revenue needs, and where the most important issue in this case is, and always has been, the duty of the Commission to develop a rational theory and make reasoned findings in dealing with the critical problem of the railroads' revenue needs.

STATEMENT

The statements of the case contained in appellants' briefs do not adequately set forth the context in which the questions presented to this Court arose, particularly those questions which involve issues raised before the Commission and before the district court by these appellees. The Midwestern railroads describe the case almost exclusively as a controversy among railroads (Midwestern Brief, pp. 5-14). And the Government seems to adopt the same view, failing even to mention the position that was taken before the Commission and the district court by these interveners. The public interest aspects of the case have thus largely been ignored by the appellants.

This case involves economic issues of the broadest scope and of the utmost importance. It is both a direct consequence of, and an effort to curtail, the extraordinary growth of the West,[1] and particularly of the State of Cali-

[1] As used in this brief, the term "West" is synonymous with the term "Mountain-Pacific territory," as used in the Commission's reports. Similarly, we shall use the term "Western railroads" to refer to the railroads serving the West, which the Commission refers to as the Mountain-Pacific railroads, and at times, as the Transcontinental railroads.

fornia, during the past four decades. As the Commission itself here pointed out, during that period the population of the eleven States which comprise the West has more than doubled (R. 1015). The population of the State of California has increased even more rapidly, having more than doubled since 1940. California is now the most populous State in the entire country.

The phenomenal growth of the population of the West over the past 40 years has been accompanied by a similar growth in industrial development. Literally thousands of new industries have grown up in the West, both to serve the West's own increasing population and to compete for nation-wide markets with industries located in other areas of the country.

The development of the West has resulted in tremendous changes in other sections of the country, particularly in the Northeast and Midwest. In the 1920's, these two sections of the country had virtually exclusive control over American industry. The growth of industry in the West not only destroyed this control, but also encouraged companies to leave the Northeast and Midwest, either completely or by establishing Western affiliates.

The revolution in American industry had profound effects upon the country's transportation system. The railroads were particularly affected because of the enormous investment in facilities and equipment necessary to provide rail service. The shifting of population and industry to the West increased the revenues of the Western railroads, but, at the same time, it placed upon those railroads the added costs of increasing their investments in facilities and equipment in order to meet the growing demands for transportation services. The seriousness of the problem created by these new investment costs soon became apparent, for the

increased revenues which resulted from the increase in transportation business proved insufficient to cover even the additional expenses of handling that business, much less the additional investment costs incurred. Thus, the record here shows, and the Commission itself recognized, that "in the 5-year period 1951-1955 the Mountain-Pacific roads found it necessary to increase their net investment in transportation property by $800 million . . . but this increase in investment produced not one penny of earnings" (R. 1026). No party to this proceeding questioned the fact that this period was characteristic of the situation of the Western railroads throughout the period of Western expansion.

By contrast, the Eastern and Midwestern railroads were faced with a certain and substantial loss of revenue from this development, both directly, as a consequence of the loss of population and industry to the West, and indirectly, as a consequence of the loss of business occasioned by the loosening of Northeastern and Midwestern control over the nation-wide markets. This loss of business was serious to these railroads because of the substantial investments in the existing rail networks of the East and Midwest. Such networks, built to serve relatively small areas on the assumption that they would contain virtually all of America's industry, simply could not be maintained without drastic changes in an era in which that monopoly had been broken.

This divisions case represents an effort by the Eastern and Midwestern railroads to maintain overbuilt rail networks that are no longer necessary, in their present form, to serve the industry and people of the Northeast and Midwest. The case was begun by separate complaints filed before the Interstate Commerce Commission on behalf of the Eastern and Midwestern railroads, alleging that their divisions of joint rates on freight traffic moving to and from

the West were unlawfully low. The divisions in question are made according to formulas that have been in effect for many years. The basic Eastern divisions were established by agreement of the parties in 1922 (R. 988); the Midwestern divisions are also of long standing, important features of these divisions having been approved by the Commission in 1934 (R. 990).

The principal thrust of the complaints filed before the Commission by the Eastern railroads and by the Midwestern railroads is that these agreements and the Commission's decision approving one of them are outmoded and that the divisions of transcontinental rates should be adjusted to reflect the changed economic conditions since that time. Specifically, the Eastern railroads and the Midwestern railroads asked the Commission to exercise its power under Section 15(6) of the Interstate Commerce Act and to prescribe for them new divisions to meet the higher cost of service and the greater revenue needs from which they claim to suffer as a consequence of the growth of the West.

The People of the State of California and the Public Utilities Commission of California intervened because these complaints raised far-reaching issues involving the right of the West to a transportation system adequate to sustain its growth over the past forty years and to permit continued growth in the future. In our view, the needs of the Western railroads for the revenues necessary to provide the transportation facilities required to sustain this growth were at least equal to the needs for revenues by the Eastern and Midwestern railroads, which are retrenching in the face of declining markets. Because the claims advanced by the Eastern and Midwestern railroads posed a direct threat to the availability of this needed revenue, our participation in the proceedings before the Commission was largely concerned

with that issue. We urged the Commission to give close consideration to, and make specific findings on, the revenue needs of all the railroads under the present economic conditions before it made any order changing the existing basis of transcontinental divisions in any way.

In this respect, our position was different from that taken by any other party to the Commission's proceedings. In our view, the existing basis of divisions, representing the railroads' own mutually established determination of a fair apportionment of the revenues prior to the economic changes which accompanied the growth of the West, was the single most important factor in the case. The soundness of this basis of divisions was proved by the fact that it had permitted the railroads to respond to economic changes through a reallocation of resources necessary to provide service to the growing West. Hence, we naturally opposed any change in divisions that might slow down the normal process of economic change. At the same time, however, we did not support the Western railroads' request that their divisions be increased to create a fund which would accelerate the rate of economic change. Our position was, and is, that in the absence of exceptional circumstances not here present, the Commission's divisions-making power should not be used either to speed up or slow down the normal processes of economic change and redistribution of industry in the Nation's economy. Accordingly, we asked that the Commission maintain the existing basis of divisions.

The Commission substantially ignored our position in its reports. In its original report, the Commission did not even acknowledge that we had defended the existing divisions, but brushed our contentions aside with those of other parties who had contended "that the public interest warrants increases in the divisions of the Mountain-Pacific

railroads" (R. 1033). Hence, when the Commission held the question of the original fairness of the Midwestern railroads' divisions to be "of little moment . . . in view of changes which have occurred in the intervening years" (R. 1034), it did so without any reference to our contention that the existing divisions should be maintained notwithstanding changes in economic conditions in order to avoid artificial barriers to the free flow of transportation resources. In its report on reconsideration, the Commission finally recognized that California had taken a position in support of the existing divisions (R. 1058), but it did not attempt to deal with that position beyond adhering to its previous determination that "changes which have occurred in the intervening years" made the question of the original fairness of the existing divisions irrelevant.

The Commission did agree with our contention that relative revenue needs was the primary factor to be taken into account in making divisions of the revenues involved in this case (R. 1032):

> "From our consideration of the cost evidence previously discussed in this report we are convinced that the present divisions are favorable to the defendants to an extent not justified by ascertainable cost differences. The evidence, however, does not provide an acceptable pattern for readjusting the existing divisions, which must reflect certain broader aspects of revenue need."

But it then proceeded to order increases in the divisional shares of the Eastern and Midwestern railroads, without finding either what the revenue needs of the various groups of railroads actually were, or the effect its new divisional order would have upon the Western railroads which were

to bear the brunt of the increases ordered for both the East and the Midwest. The arguments advanced by these appellees and others with respect to the specific revenue needs of the Western railroads were largely ignored or brushed aside on tangential and totally irrational grounds, the Commission's view being that the issue was not one of specific needs at all, but rather one of generalized judgment which it was entitled to make without explanation either of its result or the process by which that result was reached (R. 1067-1068):

> "There is no single yardstick or criterion which can be employed in determining fair divisions. *Baltimore & O. R. Co. v. United States,* 298 U.S. 349, 359. The question of what constitutes just and reasonable divisions involves the making of practical judgments and cannot be solved as though it were a mathematical problem. *Boston & Maine R.R. v. United States,* 208 F. Supp. 661, 675. In every divisions case it is customary to receive evidence relating to revenue need, the term which briefly covers 'the amount of revenue required to pay their respective operating expenses, taxes, and a fair return on their railway property held for and used in the service of transportation.'
>
> "Our authority under the above provision of section 15(6), which requires due consideration, among other things, to revenue need, is not limited in concept or scope. We are thereby authorized 'to take into account and give due weight to revenues from all transportation service, the operating expenses and taxes chargeable to the same and the amounts available as compensation for the use of all carrier property,' as well as 'the revenues, expenses, taxes and returns attributable to the service covered by the divisions under consideration.' *Baltimore & O. R. Co. v. United States,* 298 U.S. 349, 360, 370. We are free to give such evidence the weight which the particular circumstances appear to justify...."

The Western railroads attacked the Commission's orders in the district court, and these appellees filed their intervening complaint also urging that the orders be set aside. After hearings, the district court agreed that the Commission's orders were unlawful and thereupon entered the judgment setting aside those orders from which these appeals are taken.

SUMMARY OF ARGUMENT

A basic defect in the Commission's orders in this case is that, although those orders purport to be based upon the revenue needs of the railroads involved, the Commission did not find either the amount of the railroads' needs or the effect of its orders. This constitutes a flagrant violation of Section 8(b) of the Administrative Procedure Act (5 U.S.C. § 557(c)), which requires that all decisions of the Commission be supported by reasoned findings. This Court has held that this requirement is to be strictly enforced. *Burlington Truck Lines v. United States,* 371 U.S. 156 (1962). And it is well established that the requirement applies to the prescription of divisions under Section 15(6) of the Interstate Commerce Act (49 U.S.C. § 15(6)).

In setting aside the Commission's orders here under Section 8(b), the district court relied principally upon this Court's decision in *Chicago, Milwaukee, St. P. & P. R. Co. v. Illinois,* 355 U.S. 300 (1958), holding that in a rate case based upon revenue needs, the Commission must find the amount of the revenue needs to be met. This holding is squarely in point here, for an intelligible revenue needs finding is no less necessary in a divisions case than in a rate case. Appellants claim that the Commission's findings with respect to the rates of return of the various groups of railroads involved was a sufficient determination of the amount

of the revenue needs of the railroads, but this plainly is not so. Revenue needs are not equivalent to rates of return, for one group of railroads with a higher rate of return may have a greater need for revenue than another group with a lower rate of return. This is precisely the situation here, for the Western railroads are faced with investment responsibilities far greater than those facing the Midwestern railroads. The revenue needs issues in this case therefore revolved, not around the rates of return of the railroads, but around their actual need for revenue for future operations. Hence, the Commission's rate of return findings were not, and could not have been, relied upon by the Commission as dispositive of the revenue needs issues in this proceeding because such findings do not resolve those issues.

In any event, even if the rate of return findings could be treated as a sufficient determination of revenue needs, the Commission's action here could not be supported, for the Commission failed to find the effect of its orders. Thus, whatever the Commission's understanding of its aim in meeting revenue needs might have been, it did not find, and could not rationally have concluded, that the orders in question here were appropriate to serve that aim. Appellants seek to cure this defect by supplying a figure from outside the record as to the effect of the orders, but this is flagrantly unlawful. And the same is true of appellants' further efforts to describe that extra-record figure as "moderate," so as to take advantage of the Commission's characterization of certain of the Midwestern increases as "moderate." The Commission did not rely upon any determination that the effect of the Midwestern divisions was to produce "moderate increases," but, instead, expressly held that the effect of the orders was irrelevant. The Commission's orders must be upheld, if at all, upon that ground.

Securities & Exchange Commission v. Chenery Corp., 332 U.S. 194, 196 (1947). Since the ground stated by the Commission is in direct conflict with this Court's decision in the *Milwaukee Road* case, the orders must be set aside.

The Commission also made a separate error in its treatment of the revenue needs issue when it discounted the revenue needs of the Western railroads because of their higher passenger deficits. The theory of this action was that the Western railroads could save enough money through discontinuance of unprofitable passenger service to meet their revenue needs and still bear the burden of increased transcontinental divisions for the Eastern and Midwestern railroads. Although appellants sought in the district court to ignore the Commission's action in discounting the Western railroads' revenue needs and expressly denied that such action rested upon the notion that the Western railroads were running too many passenger trains, they now concede that the Commission's discussion of the subject can only be explained on the theory that it regarded the Western railroads' passenger deficits as "presumably not permanent in nature." The essential question before this Court then is whether the Commission acted lawfully in concluding that the Western railroads' passenger deficits are not permanent in nature.

We submit that this action of the Commission was patently unlawful in that it is wholly unsupported by evidence in the record and no hearing was held on the issue. No party to this proceeding has ever charged that the Western railroads passenger deficits are excessive. This idea was injected into the case by the Hearing Examiners who found, on the basis of evidence outside the record, that the Western railroads could have saved up to $67.8 million a year by a reduction in their passenger deficits. The Western

railroads denied that this was so and sought a hearing on the matter, but the Commission refused either to accord them hearing or to drop the Examiners' passenger deficit theory. In these circumstances, reliance upon the passenger deficit theory constituted a plain violation of the parties right to a full hearing. *ICC v. New York, N.H. and H. R. Co.*, 372 U.S. 744 (1963).

Appellants now urge the Court to disregard all of these errors in the Commission's treatment of the issue of revenue needs on the theory that these errors were largely harmless because the Commission actually based its order upon its findings with respect to relative cost of service. There is no merit to this position, for the Commission *expressly* stated that its order was not based upon costs but was designed to "reflect certain broader aspects of revenue need." Appellants claim that this statement applied only to the Eastern divisions, but this position cannot be supported on the basis of the language of the Commission's reports, as the appellants themselves recognized in the district court, where they asked the court to uphold the Midwestern divisions *as justified by this very finding*. Appellants' efforts to have this Court reverse the judgment of the district court for treating the orders as based upon revenue needs is thus flatly inconsistent with the position they took in that court.

Appellants' new position also obscures the fact that the Commission's orders here are based upon a wholly irrational and unlawful approach to the single most important issue in this case from the standpoint of the public—that is, the revenue needs of the carriers involved. The California Public Utilities Commission is vitally interested in this aspect of the case, for it must deal with the revenue needs of the railroads which serve California on a day-to-day basis in a variety of proceedings. If the revenue needs

of those railroads are ignored or improperly discounted in this case, it is certain to follow that the California Commission will be called upon to meet those needs in some other case, perhaps through higher rates or permission for the discontinuance of passenger service. The Commission's decision here not only creates that very possibility but actually encourages the railroads to take a position directly contrary to the policy of State of California by attempting to discontinue needed passenger service. Plainly, the Commission has no power to do this except in a proper proceeding and after a full hearing on the merits of such a proposal, and neither of those conditions were met here.

ARGUMENT

The basic issue before this Court is the same issue presented to and decided by the court below—namely, whether the Interstate Commerce Commission may declare existing divisions unlawful and prescribe new divisions on the asserted basis of the revenue needs of the railroads involved without rationally and lawfully determining what the revenue needs to be met amount to or how its orders are related to such needs. It is the position of the People of the State of California that the Commission's treatment of the revenue needs issue in this case was unlawful in at least two separate respects: (1) The Commission violated Section 8(b) of the Administrative Procedure Act in prescribing divisions based in part expressly upon revenue needs without finding either the extent of the needs involved or the financial effect of its orders; and (2) Such findings as the Commission did make with respect to revenue needs are based in substantial part upon data which unlawfully discount the needs of the Mountain-Pacific rail-

roads because of their passenger deficits.[2] We shall also show that these errors are highly prejudicial to the interests of the People of the State of California and the public interest generally.

I. The Commission Violated Section 8(b) of the Administrative Procedure Act in Prescribing Divisions Based in Part Expressly Upon Revenue Needs Without Finding Either the Extent of the Needs Involved or the Financial Effect of Its Orders.

A plain legal defect in the Commission's reports is that although the increases prescribed in the divisions of both the Eastern and Midwestern railroads were based in substantial part expressly upon the supposedly greater revenue needs of those carriers as compared to the needs of the appellee Western railroads, the Commission did not find either what the revenue needs of the respective carriers are or what effect the new divisions would have on such unmeasured revenue needs. No such findings were made even on a "group basis," much less with respect to any individual carriers. This is a fundamental error which vitiates the Commission's action.

The controlling provision is Section 8(b) of the Administrative Procedure Act, which provides that the Commission must state:

> "findings and conclusions, and the reasons or basis therefor, on all the material issues of fact, law, or discretion presented on the record..." (5 U.S.C. § 557(c)).

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[2] The district court also found the Commission's treatment of the revenue needs issue unlawful in that it reflected a failure to give consideration to the situation of certain individual carriers (R. 1727-1731, 1732), and we agree with this holding. However, since this aspect of the district court's holding will be dealt with fully by other appellees, we shall restrict our argument to the lawfulness of the Commission's treatment of the revenue needs issue on a group basis.

This Court has made it plain that this provision is to be enforced. A leading case on this point is *Burlington Truck Lines v. United States,* 371 U.S. 156 (1962), where an order of the Commission was set aside because the Commission failed to state the reasons underlying its choice of remedial action. The Court said (371 U.S. at 167-168):

> "There are no findings and no analysis here to justify the choice made, no indication of the basis on which the Commission exercised its expert discretion. We are not prepared to and the Administrative Procedure Act will not permit us to accept such adjudicatory practice. See *Siegel Co. v. Federal Trade Comm'n.,* 327 U.S. 608, 613-614. Expert discretion is the life blood of the administrative process, but 'unless we make the requirements for administrative action strict and demanding, *expertise,* the strength of modern government, can become a monster which rules with no practical limits on its discretion.' *New York v. United States,* 342 U.S. 882, 884 (dissenting opinion). 'Congress did not purport to transfer its legislative power to the unbounded discretion of the regulatory body.' *Federal Communications Comm'n. v. RCA Communications, Inc.,* 346 U.S. 86, 90. The Commission must exercise its discretion under § 207(a) within the bounds expressed by the standard of 'public convenience and necessity.' Compare *id.* at 91. And for the courts to determine whether the agency *has* done so, it must 'disclose the basis of its order' and 'give clear indication that it has exercised the discretion with which Congress has empowered it.' *Phelps Dodge Corp. v. Labor Board,* 313 U.S. 177, 197. The agency must make findings that support its decision, and those findings must be supported by substantial evidence. *Interstate Commerce Comm'n v. J-T Transport Co.,* 368 U.S. 81, 93; *United States v. Carolina Carriers Corp.,* 315 U.S. 475, 488-489; *United States v. Chicago, M., St. P. & P. R. Co.,* 294 U.S. 499, 511. Here the Commission made no findings specifically directed to the choice between two

vastly different remedies with vastly different consequences to the carriers and the public. Nor did it articulate any rational connection between the facts found and the choice made."

The duty to "articulate a rational connection between the facts found and the choice made" is fully applicable to the Commission's determination of new divisions. The applicability of this requirement of the Administrative Procedure Act to a proceeding involving the division of joint rates was considered in *Atchison, T. & S. F. Ry. Co. v. United States*, 225 F. Supp. 584, 606-607 (D. Colo. 1964):

> "The Supreme Court has recently emphasized that [Section 8(b) of the Administrative Procedure Act] is intended to have teeth [quoting from the *Burlington* case].
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> * * * * * * *
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> "It is argued by the defendants that in the Burlington case the Commission was concerned with 'the choice between two vastly different remedies with vastly different consequences to the carriers and the public,' and that the strict requirement of findings and reasons does not apply in the instant case, where the choice is among a variety of divisional scales. *We think that the requirement should not be relaxed here, for the necessity for us to determine whether the Commission exercised its discretion within the bounds of 'due consideration' to efficiency, revenue needs, public interest, and any other facts entitling one carrier to a greater or less proportion of a joint rate, is as great under Section 15(6) as it is to determine the bounds of 'public convenience and necessity' under Section 207(a)*" (emphasis supplied).

The requirement of reasoned findings to support the Commission's choice of remedies was thus applied to invalidate its prescription of divisions in a case presenting issues very similar to those before this Court (225 F. Supp. at 607).

In the instant case, the district court recognized this requirement of Section 8(b), and held that in any case where the issue before the Commission is the amount of revenue which a carrier should receive from one part of its business in order to insure a fair contribution to its overall revenue needs, an essential prerequisite to decision is a determination of the amount of revenues necessary to meet those needs (R. 1724-1725). In so holding, the court below expressly relied both upon the *Burlington* case and upon the holding of this Court in *Chicago, Milwaukee, St. P. & P. R. Co. v. Illinois,* 355 U.S. 300 (1958), a case involving an increase in intrastate passenger fares assertedly to meet revenue needs of the Milwaukee Road. In setting aside the Milwaukee Road order, the Court expressly relied upon the failure of the Commission to make findings as to just what the needs of the carrier sought to be met by the order were, saying (355 U.S. at 309-310, note 8):

> "It is axiomatic that to know whether something is a fair proportionate part of something else, we must be told what the something else is."

This principle is even more clearly applicable to a divisions case. Without determining the amounts of the revenue needs of the carriers involved, how could the Commission rationally and lawfully prescribe a radical change in divisions on the asserted ground of revenue need? Without determining the revenue effect of its orders, how could the Commission determine whether the contributions which it was ordering to be made to the Midwestern railroads were not in excess of the contribution which transcontinental freight traffic should make to the revenue needs of those railroads? Without determining both of these facts, how could the Commission rationally determine whether the divisions were "just, reasonable, and equitable," as re-

quired by Section 15(6), in light of the relative revenue needs of the carriers involved? Since determination of these factors is inherent in any rational decision of these material issues, the Administrative Procedure Act requires that findings be made on all basic facts necessary to explain and justify the Commission's decision.

Appellants do not even attempt to distinguish the applicability of the *Milwaukee Road* case to any decision based upon revenue needs. The Government does not mention the case at all. And the Midwestern appellants seek to avoid its application on the sole ground that "the Commission here did not increase the Midwestern divisions to meet all or a part of some undertermined revenue need . . ." (Midwestern Brief, p. 50, note 40). But appellants are in error in urging that the Midwestern divisions can be defended without regard to the Commission's reliance upon revenue needs, as will be shown in detail below (pp. 35-40). Hence, their purported distinction of the *Milwaukee Road* case is not sound and that case must be regarded as controlling here.

The requirements of the *Milwaukee Road* case plainly were not met in the Commission's reports. Appellants argue, without specific reference to the *Milwaukee Road* case, that the Commission's findings with respect to the overall rates of return of the various groups of carriers are a sufficient determination of revenue need (Government Brief, pp. 48-51; Midwestern Brief, pp. 54-60), but this is plainly not so. As stated above, the critical revenue needs issues before the Commission grew out of the vastly different economic situations in which the various groups of railroads involved here found themselves. The Eastern railroads and the Midwestern railroads are overbuilt in terms

of the present economies of the regions which they serve.[3] The railroads operating in the Far West on the other hand, serve a region which faces a critical need for additional transportation facilities. The basic revenue needs issues before the Commission related to the problem of deciding just what the actual needs of the railroads involved were. Were there substantial differences in the investment costs faced by the various groups of railroads? To what extent were the Eastern and Midwestern railroads' operations affected by over-capacity? To what extent did the Mountain-Pacific railroads face a need for making expenditures without any prospect of recovering such expenditures through increased revenues in order to bring the level of rail service in the West up to that already enjoyed in the East?

The Commission failed utterly in its duty to resolve these issues. Although the revenue needs issues presented by the parties could only be resolved by consideration and evaluation of the actual needs of the various groups of railroads in the particular differing economic situations in which they operated, the Commission made no findings at all

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[3] This difference is shown by uncontroverted evidence in the record, having been expressly admitted by the Eastern and Midwestern railroads themselves. The president of the New York Central Railroad testified, for example (Transcript of Hearings before the Interstate Commerce Commission, p. 1486):

> "You have to contract facilities today in the East rather than expand them."

The Pennsylvania Railroad witness agreed that Eastern roads have "shrinking plants" (Transcript, pp. 381-382, 9830). The contraction of railroad plant in the East and Midwest is exemplified by Pennsylvania's program to eliminate thousands of miles of track (Exhibit T-336, p. 37; Transcript, pp. 9830-9831), the New York Central's program for eliminating mileage of "unnecessary tracks" (Exhibit T-106, p. 20) and the Chicago & North Western Railway's program for abandonment of line and other elimination of excess track (Exhibit T-350, pp. 17-19; Exhibit MW-453).

related to such matters. Instead, it merely reviewed the rates of return of the various groups of railroads and compared their theoretical earnings as freight carriers, by excluding their respective passenger deficits,[4] without even trying to determine by any rational standard just what the revenue needs of the various groups of railroads actually would be. The Commission simply shrugged off this part of its responsibility (R. 1033):

> "We are unable to agree with the defendants and the interveners that the public interest warrants increases in the divisions of the mountain-Pacific railroads in order to provide a source of investment funds required for enlarged facilities commensurate with industrial development in that region. The railroads in all sectors of the country are faced with the continuing necessity of raising funds for additions and betterments and new equipment, and we cannot recognize any difference in the degree of this urgency among the territorial groups."

Although the Midwestern railroads now seek to make it appear otherwise (Midwestern Brief, p. 59, note 52), this cryptic pronouncement plainly does not satisfy the requirement of Section 8(b) of the Administrative Procedure Act. Indeed, it does not even attempt to meet the contention advanced by California that the divisions of the Western railroads should be maintained at the existing level in order to provide the revenue needed for transportation facilities in the West. The uncontroverted evidence before the Commission showed a wide difference between the investment costs faced by the railroads serving California

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[4] As pointed out below (pp. 26-35), this passenger deficit theory represented an independent error of the Commission, which the district court quite properly condemned, and upon which the district court's judgment could, if necessary, be independently sustained.

and those serving the Eastern and Midwestern areas where industry is declining and the railroad system is already overbuilt (R. 143-145, 291-293), and the Commission did not deny this.[5] Yet the Commission did not even consider whether, in view of the need for revenues to meet such investment costs, the existing basis of divisions should be retained. Accordingly, the following issue was presented to the district court, which was included as Issue No. 19 in the stipulated List of Issues Remaining in Controversy prepared by the parties at the direction of the district court (R. 1338):

> "19. Whether plaintiffs' and intervening plaintiffs' claim that differences in requirements for investment funds for equipment and facilities commensurate with industrial development in the territories served by the respective carriers should be considered in determining revenue needs was a material issue within the meaning of Section 8(b) of the Administrative Procedure Act; and, if so, whether the Commission stated findings and conclusions, as well as the reasons or basis therefor, upon such issue?"

The district court resolved this issue by holding that the issues which we presented to the Commission were material and, therefore, that "findings must be made as to the amount of revenues, *in terms of dollars*, required by the respective carriers affected in any new divisions prescribed . . ." (R. 1733) (emphasis supplied). Appellants criticize this holding that revenue needs findings must be made in terms of dollars (Midwestern Brief, pp. 51-61; Government Brief, pp. 45-51), but no effort is made to suggest any other standard for measuring revenue needs which would have resolved the basic revenue needs issues before the Commis-

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[5] Indeed, elsewhere in the report, the Commission affirmatively and explicitly recognized the different economic and transportation conditions in the various parts of the country (R. 1015).

sion. Certainly, the contention that rates of return are in themselves adequate—which contention is the only one appellants have made, either before the district court or in their briefs here—is unsound. The whole revenue needs issue presented to the Commission was to what extent nominal rates of return had to be adjusted to measure actual revenue needs. A recital of group average rates of return does not resolve that issue.[6]

The district court was thus eminently correct in holding that the Commission had to go further in order to fulfill its duty in this case. Section 8(b) of the Administrative Procedure Act unequivocally requires that the Commission make findings on all material issues before it. Since the revenue needs issue was not only material but critical under the view the Commission chose to use as the basis of its decision here, it was imperative that its findings on that issue be stated in terms which would rationally resolve the controversy between the parties.[7]

Moreover, even if rates of return were sufficient to measure the "amount of revenue required," the fact remains that the Commission did not find, in any form, the *effect* of the divisions which they prescribed upon the "amount of revenue required" by the carriers, from the standpoint either of

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[6] This, of course, is not to say, as the Government would have the Court believe, that we are urging that the Commission is prohibited from considering rates of return (Government Brief, pp. 50-51) or, for that matter, from relying upon them where they actually resolve the revenue needs issues presented.

[7] This defect in the Commission's reports is entirely separate and independent from any requirement that the Commission make findings with respect to the revenue needs of individual carriers. Under Section 8(b), the Commission was under an obligation at least to make meaningful and rational findings to measure the revenue needs of the carrier groups with which it was dealing. Accordingly, the district court was correct in setting aside the Commission's orders under Section 8(b), whether or not it was correct on the individual carrier issue.

cost of service or revenue needs. This lack of findings on an obviously material issue constitutes a plain violation of the requirement of Section 8(b) of the Administrative Procedure Act. Here, too, the *Milwaukee Road* case is controlling.

Appellants' sole defense of this aspect of the Commission's action is that the Commission found that the Midwestern lines "should be given 'moderate increases' in their divisions" (Midwestern Brief, p. 60; Government Brief, p. 51), and that this finding constituted an adequate description of the effect of the Commission's orders, at least as far as the divisions prescribed for those lines are concerned.[8] But the Commission's use of the term "moderate increases" does not satisfy the *Milwaukee Road* case. Indeed, the term "moderate increases" in this context is so vague that it has no meaning at all. If there were any doubt on this score, that doubt should be dispelled by the fact that reliance is sought to be placed upon the term to justify the overall revenue effect of the prescribed divisions upon those eight Midwestern appellants. By their own admission, these appellants would receive an increase in their revenues of at least $11,638,000 a year under the new divisions (Midwestern Brief, p. 73, Appendix D), and as they further point out, such an amount represents an increase of 11 per cent in their revenues from transcontinental traffic (Midwestern Brief, p. 74). *An increase of 11 per cent is not a moderate*

[8] Neither the Midwestern railroads nor the Government make any effort to explain in any way the failure of the Commission to make any finding, either in precise dollar amounts or by general description, as to the effect of the new divisions prescribed for the Eastern lines. Since it is expressly conceded that "The Commission increased the divisions of the Eastern lines on the basis of both costs and revenue needs" (Midwestern Brief, p. 46), appellants impliedly concede that when the Commission's orders are considered as a whole, they reflect the totally irrational action of prescribing divisions on the basis of revenue needs without finding either specifically or generally, what the revenue effect of such divisions will be.

increase. If all the Midwestern railroads had received such an increase, including those which have since settled their disputes with the Western railroads and, hence, are not appellants in this Court, the total impact of the orders on all Midwestern railroads would have been an increase in their divisions of more than $31 million a year.[9] When it is remembered that the plain purpose of the Commission was to give the Eastern railroads *greater* increases than those given to the Midwestern railroads,[10] the absurdity of characterizing a percentage increase which would have that sort of effect upon the Midwestern railroads as a whole as "moderate" is apparent.

Of course, the divisions prescribed would not increase the revenues of all the Midwestern railroads by $31 million a year. For some of the Midwestern railroads did receive only moderate increases, and two of these railroads would actually have incurred losses under the prescribed divisions. As already noted (see note 2, *supra*), the district court regarded the fact that some railroads were treated much worse than others under the prescribed divisions as one of the further defects in the Commission's orders. But for present purposes that is irrelevant, for these Midwestern appellants cannot defend divisions prescribed for them as involving only "moderate increases" on the ground that other Midwestern lines did receive moderate increases. The important thing here is that when the term "moderate increases" is stretched to cover increases as great as 11 per cent in the overall revenues of a group of carriers, the term

[9] This calculation is based upon the sum of the present Midwestern revenue on Official-transcontinental traffic ($125,319,000) (R. 984) and the present Midwestern revenue on Midwest-transcontinental traffic ($160,285,000) (R. 987). Eleven per cent of the total Midwestern revenue ($285,599,000) would be $31,415,890.

[10] The Midwestern appellants themselves recognize this aspect of the Commission's order (see Midwestern Brief, pp. 22-23).

becomes meaningless. It certainly does not constitute a rational determination of the revenue effect of an order based in substantial part upon revenue needs.

Moreover, the Commission itself placed no reliance upon the phrase "moderate increases" as determining the financial effect of its orders. Quite the contrary, the Commission squarely held that findings as to the financial effect of its orders are wholly unnecessary in divisions cases because the prescription of divisions is a matter of administrative expertise within its discretion (R. 1068):

> "There is no rule, statutory or otherwise, requiring that, as a condition to the exercise of our authority in cases involving divisions, we must find in terms of dollar amount the difference between the revenue produced by lawful divisions as compared to the revenue produced by unlawful divisions."

Hence, under the principle announced in *Securities & Exchange Commission v. Chenery Corp.*, 332 U.S. 194, 196 (1947), that an administrative order must be upheld, if at all, on the ground relied upon by the agency, the Commission's use of the term "moderate increases" should not even be considered in determining the sufficiency of its findings with respect to the effect of its orders.

II. Such Findings as the Commission Did Make with Respect to Revenue Needs Are Based in Substantial Part Upon Data Which Irrationally and Unlawfully Discount the Needs of the Western Railroads Because of Their Passenger Deficits.

The absence of adequate findings as to the amount of the revenue needs of the carriers and the financial effect of the prescribed divisions require that the Commission's orders be set aside under Section 8(b) of the Administrative Procedure Act, even if we concede the lawfulness of the sub-

stantive standards underlying the Commission's revenue needs conclusions. However, there are also legal defects in this substantive aspect of the Commission's treatment of the matter of revenue needs and these defects constitute an independent ground requiring that the Commission's orders be set aside.

The defects in question relate to the Commission's action in discounting the revenue needs of the Western railroads because of their passenger deficits. It is California's position that this action underlies, and constitutes a substantial part of the basis for, the Commission's determination of virtually every one of the revenue needs issues presented to it, and that such an approach is unlawful on several grounds. The situation can be illustrated by reference to one of the revenue needs issues which the Commission decided.

At the hearings before the Commission, the Western railroads included in their showing of their actual revenue needs a showing of the need for additional investment in railway property necessary to meet the growing service requirements of the territory which they serve. This showing established that the Western railroads have found it necessary to increase their investment in railway property at a substantially greater rate than have the Eastern and Midwestern railroads (R. 143-145, 291-293). The Western railroads also showed that their actual earnings from all transportation services had not increased to support their increased investment. It was uncontroverted that an increase in their net investment in railway property of $800 million had not produced one penny of increased earnings, as the Commission noted (R. 1026). Taking account of all funds available from their transportation operations, and deducting all funds devoted to railroad operations and in-

vestment in railroad facilities, the balance available for the owners of the Western railroads was only 1.07% of the stockholders' investment in transportation property for the period 1951-1955; the Eastern and Midwestern railroads produced funds available for stockholders at the rate of 1.40% and 1.79% respectively (R. 143).

The Commission rejected this showing of the actual revenue needs of the Western railroads, stating (R. 1033):

> "The railroads in all sections of the country are faced with the continuing necessity of raising funds for additions and betterments and new equipment, and we cannot recognize any difference in the degree of this urgency among the territorial groups."

This conclusion was based upon specific findings of the Commission explaining why the differences shown in investment needs could not be recognized. The Commission first found that the overall rates of return which were used as the starting point of the Western railroads' analysis had to be adjusted (R. 1023):

> "In comparing net railway operating income and rates of return based thereon, differences in respect of the passenger deficit, which have an important bearing on such comparisons should also be considered."

The Commission then recited figures representing "passenger deficits" and the "complementary" figures called "net railway operating income—freight" (R. 1023-1024), which showed that the passenger deficits of the Western railroads have been increasing in substantial amounts in recent years, whereas those of the Midwestern railroads have been increasing to a much lesser extent and those of the Eastern railroads have been declining.

On the basis of these statistics, the Commission discounted the actual revenue needs of the Western railroads

to eliminate what it regarded as the improper effect of these higher passenger deficits. In the Commission's view, the important factor to be considered was what it termed "the financial position of the mountain-Pacific lines as freight carriers" (R. 1025), and several revenue needs contentions advanced by the People of the State of California and the Western railroads were rejected on that basis (R. 1024-1025). The Commission then turned to the showing of the Western railroads' greater investment needs and totally rejected that showing because, in its view, the revenue needs of the Western railroads resulted from the passenger deficits of those roads (R. 1026):

> "The comparisons of freight net railway operating income and passenger deficits also have a bearing on the assertion of the defendants that 'the increased investment required in serving the growing mountain-Pacific territory has produced no return for the owners of the mountain-Pacific roads.' This alleged deprivation, results from passenger deficits of those roads, as will now be explained."

In this manner, virtually every revenue needs issue presented to the Commission was determined, not in terms of the earnings experience of the carriers from all transportation services, but in terms of their situation "as freight carriers." The Commission concluded the discussion in its original report under the heading "Revenue Needs" not with a reference to the actual earnings of the carriers from all transportation services, but in terms of "freight income" (R. 1029). And the "freight income" basis of the Commission's conclusion on the revenue needs issue was reiterated and emphasized in the supplemental report. That report discussed at length and undertook to defend discounting the revenue needs of the Mountain-Pacific rail-

roads because of their passenger deficits (R. 1070-1075). The Commission again made it abundantly clear that it did not accept the Western railroads' use of net railway operating income from all services as the starting point for analysis of the relative revenue needs of the carriers because it regarded passenger deficits as "important in connection with the claimed revenue needs of the transcontinental defendants discussed in our original report" (R. 1075).

The idea that passenger deficits were the answer to the Western railroads' revenue need problems was injected into the case by the Examiners in their Recommended Report. The Examiners expressly found that a fund could be created by reduction of the Western railroads' passenger deficit (R. 744):

> "If the defendants had been able to do as well [as other railroads in reducing their passenger deficits], they would have had a saving of $67.8 million in 1959."

The Commission did not expressly repeat this conclusion but it adopted the Examiners' reasoning with respect to passenger deficits without in any way repudiating such a conclusion.

Before the district court, the People of the State of California took the position that the Commission's decision to discount the revenue needs of the Western railroads because of their high passenger deficits was contrary to Section 15(6), unsupported by rational findings, arbitrary, and denied appellees a fair hearing on this novel concept. In our view, the only possible significance that the Western railroads' high passenger deficits could have from the standpoint of their overall revenue needs would be on the assumption that such deficits could somehow be eliminated, or at least substantially reduced. We pointed out that there was nothing whatever in the record to support such a finding and that no hearing had ever been held on that question.

The defendants in the district court, including the appellants in this Court, did not even attempt to address themselves to the legal errors which we claimed to be inherent in the Commission's action, but instead, took the position that we had misconstrued the basis of the Commission's reliance upon passenger deficits because the Commission had not assumed that such passenger deficits could be reduced. Thus, the Midwestern appellants stated (Midwestern Brief before the District Court, pp. 80-81):

> "The Commission's consideration of the net earnings from freight and of passenger deficits of the Transcontinental lines did not proceed, as the Transcontinental lines charge, upon the presumption that those lines 'can increase their actual earnings and meet their revenue needs by reducing their passenger deficits.'"

The Government was even more emphatic (Government Brief before the District Court, pp. 85-86, 87):

> "Plaintiffs' main thesis (Brief 70: 13-16) is that the Commission, in considering freight net earnings in past years, proceeded on an 'iffy' assumption, namely, that the common expenses apportioned to passenger services under Commission prescribed separation rules would have been saved if a portion of the passenger services actually performed had not, contrary to what actually occured in the period under consideration, been performed."
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> * * * * * * *
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> "Plaintiffs' whole argument is without substance because there is nothing in the reports to warrant imputing to the Commission the assumption above described."

The district court did not accept appellants' characterization of the Commission's reports. Instead, it set aside the

Commission's orders and remanded the cause to the Commission with directions to consider "the revenue needs of the carriers for *all* transportation services, including needs represented by passenger deficits" (R. 1733), thus plainly indicating its acceptance of the common sense position argued by the appellees that references to passenger deficits made no sense at all unless based upon the assumption that such deficits could be controlled, and that, in the absence of a hearing or evidence to sustain such a view, reliance upon such an assumption was unlawful.

In their briefs in this Court, appellants largely abandon the position which they took in the district court. Both groups of appellants acknowledge that the Commission did in fact discount the revenue needs of the Western railroads because of their high passenger deficits (Midwestern Brief, p. 64, note 56; Government Brief, p. 16). And the Government expressly states the assumption upon which that action necessarily was taken (Government Brief, p. 16, note 10):

> "In order to obtain an accurate picture of earning power trend among the respective groups, therefore, the Commission gave some consideration to the fact that differences in passenger operating ratios, *presumably not permanent in nature*, had an effect on the income figures for the period considered in comparing the groups" (emphasis supplied).

Thus, there is no longer a dispute between the parties as to what the Commission did with its passenger deficit theory; it discounted the revenue needs of the Western railroads on the theory that the high passenger deficits of those railroads are "not permanent in nature" but could be reduced. The essential question before this Court, therefore, is whether the Commission acted lawfully in presuming that the higher

passenger operating ratios and resulting passenger deficits of the Western railroads are "not permanent in nature."

It is uncontroverted that the Commission never conducted a hearing on, or received any evidence with respect to, its theory that the revenue needs of the Western railroads should be discounted because of their high passenger deficits. Nothing in the evidence presented by the Eastern and Midwestern railroads showed that the passenger deficits of the Western railroads should be treated as "not permanent in nature." Nothing in the earnings data relied upon by any of the parties at any stage of the hearings before the Commission remotely suggested any such claim because all earnings data measured railroad earnings from all transportation services. It was not until the closing rebuttal hearing that a witness for the Midwestern railroads presented tables containing passenger deficit data for individual railroads in support of a very different point (R. 623-630).[11] Nowhere in their extensive briefs to the Examiners did either the Eastern or Midwestern railroads make the charge that the actual earnings of the Western railroads could or should be augmented by the reduction or elimination of their passenger deficits.

As noted above, the "freight carrier" concept was a creation of the Examiners. Their recommended report for the first time attributed the revenue needs problem of the Western railroads to passenger deficits and for the first time injected into the case the "freight carrier" concept of revenue needs (R. 743-744). In their Exceptions to the Examiners' Recommended Report, the People of the State of California and the Western railroads took exception to the

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[11] The sole purpose of this testimony was an effort to show that the Chicago & North Western Railway was as efficient as other carriers (R. 621).

"freight carrier" concept as unlawful and unsupported by adequate findings or substantial evidence. But this exception was completely disregarded in the Commission's report. And although the exception was renewed in the petitions for reconsideration, the Commission's supplemental report again omitted any reference to this vital issue.

In this situation, it is plain that the People of the State of California and the Western railroads have been denied their right to a full hearing under Section 15(6) by the Commission's action in discounting the revenue needs of the Western railroads on a theory injected into the case without notice and without any evidence in the record to support the use to which the Commission put that theory. Even if the Commission's passenger deficit theory could ultimately be proved to be sound, reliance upon it here would not be justified in the absence of evidence in the record. A similar point was recently decided in *I.C.C. v. New York, N.H. & H.R. Co.*, 372 U.S. 744 (1963), when the Commission chose to base its decision in a rate case on considerations of national defense without any warning to the parties. In upholding a judgment setting aside this order, this Court specifically rejected an effort on the part of counsel to support the Commission's action by evidence from outside the record and held, instead, that the matter should be the subject of a hearing (372 U.S. at 763-764):

> "We need not consider the question whether reliance on other additional sources might have been sufficient, for we believe that the question is one for initial determination by the Commission, and that all parties should have an opportunity to adduce relevant evidence, including any evidence tending to indicate that *disallowance* of the proposed TOFC rates might adversely affect the commerce or the national defense of the

country. Once raised, these considerations . . . do not exist solely for the benefit of protesting carriers."

This principle is clearly applicable here, for the record is wholly lacking in evidence showing that the Western railroads' revenue needs can be met through a reduction in their passenger deficits, and the parties have not been given an opportunity to be heard on this subject. Indeed, the appellants do not even attempt to defend the Commission's treatment of the Western railroads' passenger deficits as "presumably not permanent in nature," but, instead, seek to brush aside the entire passenger deficit discussion in the Commission's reports as unimportant, or better yet, as though it had never occurred (Midwestern Brief, pp. 61-65). But this Court plainly cannot close its eyes to a substantial portion of the Commission's reports which, on its face, purports to be the resolution of the principal revenue needs issue in the case. The Commission did announce and apply a passenger deficit theory to discount the revenue needs of the Western railroads without either a hearing or evidence to support its action. That fact alone requires that the Commission's action be set aside.

III. The Commission's Treatment of the Revenue Needs Issues in This Case Would Have a Profound Effect Upon the Public Interest if Its Orders Were Permitted to Go Into Effect.

Appellants seek to create the impression that the revenue needs issues in this case are unimportant, going so far even as to urge that the Commission did not rely upon revenue needs in increasing the divisions of the Midwestern railroads, but, instead, based its orders wholly upon cost of service (Midwestern Brief, p. 31):

> "The Commission based its decision to order moderate increases in the divisions of the Midwestern lines

on the relative cost of service and not on the more general revenue needs of those carriers."

* * * * * * *

"It was on the basis of these [cost] discrepancies, not general revenue needs, that the Commission decided to increase the divisions of the Midwestern line."

The Government unequivocally joins in this view of the case. "Considerations relating to relative costs of service and not revenue needs," the Government states, "thus governed with regard to the prescribed increases of Midwestern, as distinguished from Eastern, divisions" (Government Brief, pp. 11-12; see also pp. 47, 52, 53). Hence, in appellants' view, the principal issue before this Court is no longer whether the Commission must state standards for its action and justify its application of those standards by findings, but whether an order based upon and justified by findings on relative cost of service can be set aside for lack of consideration of revenue needs. They say, "The holding of the District Court is wrong . . . because it disregards the basis upon which the Commission increased the divisions of the Midwestern lines . . ." (Midwestern Brief, p. 44).

We think that this argument rests upon a distortion of the Commission's reports, which plainly state that the prescribed divisions are based upon revenue needs (R. 1032):

> "From our consideration of the cost evidence previously discussed in this report we are convinced that the present divisions are favorable to the defendants to an extent not justified by ascertainable cost differences. *The evidence, however, does not provide an acceptable pattern for readjusting the existing divisions, which must reflect certain broader aspects of revenue need*" (emphasis supplied).

For the first time, appellants in this Court make the incredible claim that this finding applies only to the divisions

of the Eastern railroads (Midwestern Brief, p. 47; see also pp. 47-48, note 36). If there were any doubt that this position is unsound from a mere reading of the Commission's reports, that doubt is certainly dispelled by the fact that what the appellants say here is *exactly opposite* from the position which they took in the district court with respect to this very finding (R. 1404):

> "48. The Commission made a number of findings with respect to the *scales of divisional factors prescribed for application in Midwestern* and Mountain-Pacific Territories. Among other things, the Commission in its initial report found that the divisions prescribed 'must reflect certain broader aspects of *revenue need*' and that 'Nothing in the nature of a mathematical formula to measure *such need* exists'" (emphasis supplied).

This statement of the basis upon which the Commission acted in prescribing the divisions at issue here appears in the proposed findings of fact and conclusions of law submitted to the district court by all of the defendants there, including the Midwestern appellants here and the Government (R. 1490-1491). It reflects the position repeatedly urged upon the district court by all of these appellants. For example, appellants also proposed that the district court enter the following conclusion of law (R. 1467-1468):

> "22. The Transcontinental lines contend . . . that there are no rational findings to support the contour of the prescribed scales. . . . It is sufficient that the Commission settled upon scales and scale factors which it held 'give fair recognition to the evidence as to cost of service and *revenue needs.*' (322 I.C.C. at 509.)"

In this Court, the Government's brief makes no comment on the passage from the Commission's report quoted above

from appellants' proposed conclusion of law No. 22. The Midwestern appellants attempt to explain it as referring "to the revenue needs of the Mountain-Pacific lines" (Midwestern Brief, pp. 52-53, 91), an explanation difficult to reconcile with their general position that "discrepancies between revenue from the existing divisions and the relative cost of the two groups of carriers [i.e., Midwestern and Mountain-Pacific] . . . not general revenue needs . . . led the Commission to increase the divisions of the Midwestern lines" (Midwestern Brief, p. 49). Be that as it may, appellants offered no such explanation to the district court. Proposed conclusion No. 22 said without hedging that the Commission's "scales and scale factors"—meaning Midwestern divisions, since Eastern divisions were prescribed in terms of percentages rather than scales (compare R. 1097-1099 with R. 1101-1102)—rested upon "cost of service and *revenue needs*" (emphasis added).

Appellants took the same position at oral argument. The attorney for the Interstate Commerce Commission who concluded the argument for defendants below summed up as follows (R. 1692-1693):

> "Mr. Cerra: . . . let's examine what the Commission did here. . . . Based on the cost evidence the Commission finds the existing divisions are favorable to the plaintiffs, to an extent not justified by costs, and unfavorable to the intervening defendants in this case, as their revenues are too low in relation to costs.
>
> "Now, *the Commission goes a little further.* We have that initial determination. We have some kind of a comparable basis there. What do they do next?
>
> "*They find that the Eastern and Midwestern lines in this case have greater revenue needs than plaintiffs.* . . .
>
> "What happens next? *The Commission prescribed divisions for the East and the Midwestern lines* and

they find that these divisions are required in the public interest *to maintain these groups in effective working condition*" (emphasis supplied).

Appellants' contention that the prescribed divisions can be justified on the basis of the Commission's cost findings is a patent effort to create an appearance of rationality where none exists. Having failed before the district court to justify a decision based upon supposed revenue needs which does not find either the extent of these needs or the effect of the orders designed to meet them, appellants now turn to the only argument left to them—namely, that the orders are not based upon revenue needs after all. But in repudiating the position which they took in the district court, appellants make no claim that the Commission actually found that the effect of the prescribed divisions could be justified on the basis of cost findings. Appellants concede, as they must, that the Commission made no findings as to the effect of its orders, and they seek to remedy that defect by asserting, on the basis of evidence wholly outside the record, that the prescribed divisions will increase their revenues by some $11,638,000 a year (Midwestern Brief, pp. 73-74, Appendix D). And this they seek to have the Court accept as consistent with the Commission's findings with respect to cost of service, although they nowhere show the amount of the increase to which they would be entitled under those findings. Appellants' present argument thus comes down to an effort to substitute unsupported assertion for demonstrable irrationality.

This is highly improper from the standpoint of the established principles governing the review of administrative action. *Securities & Exchange Commission v. Chenery Corp.*, 332 U.S. 194, 196-197 (1947). But far more important from the standpoint of the People of the State of Cali-

fornia, appellants' approach is an effort to obscure the fact that the Commission has acted in a totally irrational and unlawful manner in dealing with the critical subject of revenue needs. The Public Utilities Commission of California must deal with the revenue needs of the railroads which serve our State on a day-to-day basis, in rate cases, passenger discontinuance cases, and a host of other proceedings. If the revenue needs of those railroads are ignored, or unlawfully discounted, in a divisions case, they will certainly come back to haunt us in other proceedings.

The importance of revenue needs considerations, in our view, conclusively demonstrates the utter lack of a legal basis for the Commission's action in dealing with the revenue needs issues here. The revenue needs of a public utility are not, and cannot be, a question of discretion and judgment, without regard to the facts or any rational explanation or theory. In dealing with such needs, every administrative agency should carefully explain its action and the theory upon which it is based so that any other agency called upon to deal with those needs can implement its policies within its own field of competence, without conflict with other agencies. The California Supreme Court has made it plain that the California Commission must meet such standards, and, in doing so, it has succinctly set out the sound policy considerations underlying these standards (*California Motor Transport Co. v. Public Utilities Commission*, 59 Cal. (2d) 270, 274-275, 379 P. (2d) 324, 327-328 (1963)):

> "Such findings afford a rational basis for judicial review. See 2 Davis, Administrative Law Treatise (1958) § 16.05. The more general the findings, the more difficult it is for the reviewing court to ascertain the principles relied upon by the administrative agency. Even when the scope of review is limited, as in this case (Pub. Util. Code, § 1757), findings on material

issues enable the reviewing court to determine whether the commission has acted arbitrarily. (See State v. Tri-State Tel. & Tel. Co., 284 N.W. 294, 300-301; Jaffe, *Administrative Findings or The Ameer in America* (1949) 34 Cornell L.Q. 473, 492-493.) The ultimate finding of public convenience and necessity is so general that without more, a reviewing court can only guess at how it was reached. (See New York v. United States, 331 U.S. 284, 351-354 [dissent]; Vendemia v. Cristaldi, 221 F.2d 103, 104-105; Mississippi River Fuel Corp. v. FPC, 163 F.2d 433, 449; New Jersey Bell Tel. Co. v. Communications Workers, etc., 5 N.J. 354, 374-379; Klawansky v. Public Service Com., 187 A. 248, 249-250; New England Tel. & Tel. Co. v. Kennelly, 98 A. 2d 835, 837-838; Clark, *Federal Developments in Administrative Law* (1956) 44 Cal. L. Rev. 321, 334.)

"Since findings on material issues indicate the basis for the decision the parties can prepare accordingly for rehearing or review. (See Barry v. O'Connell, 100 N.E. 2d 127, 129-130.) 'Furthermore, a disappointed party, whether he plans further proceedings or not, deserves to have the satisfaction of knowing why he lost his case.' (2 Davis, Administrative Law Treatise (1958) § 16.05.) Findings on material issues are also helpful to anyone planning activities that might involve similar questions. (See Friendly, *The Federal Administrative Agencies: The Need for Better Definition of Standards* (1962) 75 Harv. L. Rev. 863, 878-879.)

"Findings on material issues can also serve to help the commission avoid careless or arbitrary action. (See State v. McPhee, 94 N.W. 2d 711, 717-718; Feller, *Prospectus for the Further Study of Federal Administrative Law* (1938) 47 Yale L.J. 647, 666; Jaffe, *Administrative Procedure Re-Examined: The Benjamin Report* (1943) 56 Harv. L. Rev. 704, 722-723.) 'Often a strong impression that, on the basis of the evidence, the facts are thus-and-so gives way when it comes to expressing that impression on paper.' (2

> Davis, Administrative Law Treatise (1958) § 16.05, quoting Judge Frank in United States v. Forness, 125 F.2d 928, 942, cert. denied 316 U.S. 694; see Frank, *Say It With Music* (1948) 61 Harv. L. Rev. 921, 949-950; Landis, *The Administrative Process, The Third Decade* (1961) 47 A.B.A.J. 135, 137.) There is no assurance that an administrative agency has made a reasoned analysis if it need state only the ultimate finding of public convenience and necessity. (See Landis, Report on Regulatory Agencies to the President-Elect, p. 53, Comm. Print 1960 of Senate Comm. on the Judiciary, 86th Cong., 2d Sess.)"

The need for the same sort of standards to be applied to the decisions of federal agencies, such as the Interstate Commerce Commission is even greater, for in view of the vast powers of those agencies, any lesser standards would make the operation of state agencies on related questions virtually impossible, even within their own fields of competence.

The Commission's action in simply increasing the Midwestern divisions here to reflect revenue needs without finding either the extent of such needs or the effect of its orders creates this very problem, for the vagueness of this treatment of the railroads' revenue needs leaves the state agencies wholly in the dark as to what the Commission's policies on this matter actually are. And the further holding that the revenue needs of the Western railroads should be discounted because of their higher passenger deficits creates a direct conflict with the policies of the California Public Utilities Commission. We do not believe that the passenger deficits of the Western railroads should be eliminated by discontinuance of all or a part of their passenger service. We have frequently refused to sanction discontinuances where there is a real public need

for the service, even where a genuine out-of-pocket loss is involved,[12] and we certainly would not do so simply to spare the accountants concern over paper deficits. Of course, we realize that the Commission has the ultimate power in this area, at least where interstate passenger service is involved (49 U.S.C. § 13a). But the States have not been completely ousted of jurisdiction, and, certainly, until a proceeding has been conducted under Section 13a and the proper state regulatory agency has been given an opportunity to participate and show the basis for its position, the Commission has no power to affect passenger service.

In the final analysis, the essential question in this case is whether the Interstate Commerce Commission is to be permitted to ride roughshod over the interests of the West without a proper hearing, without substantial evidence, and without explanation. There can be little doubt that the Commission's actions are in direct violation of the Administrative Procedure Act. We urge the Court to enforce that Act and to uphold the district court's condemnation of the Commission's orders in this case.

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[12] In doing so, we believe that we have followed the policy announced by this Court in *Southern R. Co. v. North Carolina*, 376 U.S. 93, 105 (1964), that where the public need is great, an administrative agency "would err if it did not give great weight to the ability of the carrier to absorb even large deficits resulting from such services." Here, the Commission gave no consideration to the need of the public for passenger service.

CONCLUSION

For the foregoing reasons, the Judgment of the district court setting aside the orders of the Interstate Commerce Commission in its Docket No. 31503 should be affirmed.

Respectfully submitted,

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